Nos. 22187 and 22187-A

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

IRVING NINBERG and IDA NINBERG; BEN NINBERG and MOLLIE NINBERG,

Appellants,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

On Petition to Review the Decisions of the Tax Court of the United States.

APPELLANTS' OPENING BRIEF.

HOCHMAN and SALKIN,
6222 Wilshire Boulevard,
Los Angeles, Calif. 90048,
Attorneys for Appellants.

Parker & Son, Inc., Law Printers, Los Angeles. Phone MA. 6-9171.

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Basis of Jurisdiction.

This is an appeal of the decision of the Tax Court of the United States. Appellants were mailed Notices of Deficiency by the Commissioner of Internal Revenue on or about September 25, 1964 [Clk. Tr. 9, 24]. Within ninety days thereafter (on or about December 21, 1964), appellants filed a Petition with the Tax Court [Clk. Tr. 1, 16], thereby granting jurisdiction in that tribunal pursuant to Sections 6213, 6214, and 7442 of the Internal Revenue Code (26 U.S.C.).

Jurisdiction is vested in this Court by Section 7482 of the Internal Revenue Code (26 U.S.C. 7482) which confers exclusive jurisdiction in the United States Court of Appeals to review decisions of the Tax Court.

Pursuant to Section 7483 of the Internal Revenue Code (26 U.S.C. 7483), appellants filed a Petition for Review within three months of the filing of the decision of the Tax Court [Clk. Tr. 59], thereby granting jurisdiction to this Court.

Specification of Errors.

1. The Court below erroneously determined that appellants were not entitled to deduct as a business bad debt the worthless obligations of Bur-Val Manufacturing Company, Inc., owed to appellants. The Court ruled that the deduction was allowable as a non-business bad debt rather than as a business bad debt.

2. The Court below erred in failing to question whether appellants' acts in guaranteeing the obligations of Bur-Val Manufacturing Company, Inc. were significantly motivated by appellants' trade or business. Rather, it sought their "major concern" [Clk. Tr. 54].

3. The Court below erred in failing to find that the guaranteeing of obligations of Bur-Val Manufacturing Company, Inc. was proximately related to appellants' trade or business.

4. The Court below erred in the following findings of fact:

A. "So far as the record shows petitioners would have been able to obtain more highly remunerative employment and a higher rent for the San Francisco building from another business than they were obtaining from Bur-Val." [Clk. Tr. 50].

B. "Since Bur-Val was the tenant in petitioners' building, it is obvious that putting up the collateral was for the benefit of petitioners' tenant but the only benefit shown by this record in put-

ting up the collateral to petitioners as distinguished from Bur-Val was to keep Bur-Val operating and protect their investment in Bur-Val." [Clk. Tr. 50].

C. "Furthermore, the record shows that beginning sometime in 1961, Bur-Val was not paying rent when it fell due." [Clk. Tr. 53].

Further specification of the above errors is found in the argument below.

Statement of the Case.

The Commissioner determined that deductions claimed on the joint 1962 Federal Income Tax Returns of each of the appellants in the amount of $18,806.74, claimed as a loss of the partnership known as Irving and Ben Ninberg, was erroneous. The $18,806.74 ordinary loss of each of the appellants was converted to a short-term capital loss of $21,848.94, and ordinary income of $3,240.27. This transformation was accomplished by disallowance of a deduction claimed by the partnership as a business bad debt, and allowing the same deduction as a non-business bad debt (I.R.C. §166(d), found in Appendix).

The bad debt deduction in question resulted from the satisfaction of guarantees by the appellants of obligations of Bur-Val Manufacturing Company, Inc., appellants' wholly owned corporation. Appellants urged in the Court below that the deduction was properly claimed as a business bad debt while the Commissioner contended that the deduction was allowable as a non-business bad debt—thereby deductible only as a short-term capital loss. The lower Court agreed with the Commissioner. The issue is whether the obligations arose in connection with the trade or business of appellants. (I.R.C. §166(d)(2)).

ARGUMENT.

I.

Introduction.

The rule of law relied upon by the Lower Court is summed up on page 18 of the Court's Memorandum Opinion [Clk. Tr. 55], where the Court attempts to ascertain whether there was a proximate relationship between the loans in question and the taxpayers' businesses:

> "In seeking this 'proximate connection', we must examine factors other than motivation, particularly those which illustrate the degree of *necessity* and *directness of effect* of the loan to the corporation upon the taxpayers' other business. Not only have we found lack of necessity and directness of effect, but also, we have found other objective factors which negate petitioners' expression of intent. Thus, petitioners have not proved that they were either 'significantly' or 'primarily' motivated by their other business." (Emphasis added).

Throughout the Lower Court's opinion it appears to set forth a test for determining the proximate relationship between the loans and the businesses of the taxpayers. It notes that the petitioners' investment, salary, and rental interests "were thoroughly intermingled", but that the investment in Bur-Val was the *major* concern [Clk. Tr. 54]. This conclusion—that the investment in Bur-Val was appellants' *major* concern—is not supported by the record, and the Court's finding that appellants' investment, salary and rental interests were thoroughly intermingled furnishes the significant, if not major, motivation necessary to classify the loss as a business bad debt.

The findings of the Lower Court involve the interpretation of Internal Revenue Code Section 166(d)-(2). The issue is a mixed one of law and fact, and is subject to review by this Court. The question is whether the Tax Court correctly applied the statute to the factual situation which it found to exist. *Lundgren v. Commissioner of Internal Revenue* (9th Cir., 1967), 376 F. 2d 623, 627; *United States v. Keeler* (9th Cir., 1962), 308 F. 2d 424; *Commissioner of Internal Revenue v. Smith* (2nd Cir., 1953), 203 F. 2d 310, 311; *Washburn v. Commissioner of Internal Revenue* (8th Cir., 1931), 51 F. 2d 949, 951.

In the recent case of *Generes v. United States* (E.D. La., 1967), P.H. 67-5205, 67-2 U.S.T.C. 9754, the Court's jury instructions contain what appellants consider to be the most current statement of the law on this issue. Among the instructions were:

1. "A debt is proximately related to the taxpayer's trade or business when its creation was significantly motivated by the taxpayer's trade or business, and it is not rendered a non-business debt merely because there was a non-qualifying motivation as well, even though the non-qualifying motivation was the primary one."
2. ". . . you are instructed that rendering services for pay does constitute a trade or business. An officer of a corporation who receives a salary as such is considered in the eyes of the law to be engaged in a trade or business—the trade or business of rendering services for pay."
3. "A debt is a business bad debt if the debt, or the activity giving rise to the debt, is such that without the taxpayer assuming or acquiring it

his trade or business would no longer be able to operate in the manner in which it is intended to operate."

4. The Court said the jury should consider whether the taxpayer was ". . . motivated significantly by a desire to protect his salary or whether his motivation was predominantly one of protecting his investment and future gain or investment as distinguished from his salary as an officer-employee."
5. The Court instructed the jury to further consider ". . . the amount of Mr. Generes' investment in the company which he would be protecting by signing the indemnity agreement, and what was the amount of annual salary he would be protecting thereby."

Appellants believe that each of the above instructions are supported by substantial authority cited below. The trial Court did not give proper consideration to the above tests, and for this reason was in error.

II.

Appellants' Trade or Business.

A. Business Motivated Loans as Contrasted With Investment Oriented Loans.

The Supreme Court decision in *Whipple v. Commissioner of Internal Revenue* (1963), 373 U.S. 193, 83 S. Ct. 1168, is the landmark case when considering the distinction between business and non business bad debts. This decision makes a crucial distinction between loans motivated to produce investor-type income ("dividends or enchancement in the value of an investment") and those motivated by non-investor type activities. A care-

ful analysis of the Court's narrow holding is most enlightening (373 U.S., at 202):

> "Devoting one's time and energies to the affairs of a corporation is *not of itself, and without more,* a trade or business of the person so engaged. Though such activities may produce income, profit or gain in the form of dividends or enchancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself. *When the only return is that of an investor,* the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business and the return to the taxpayer, though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation." (Emphasis added).

This Honorable Court has recently had an opportunity to consider the distinction between loans motivated to produce investor type income and those motivated by non-investor type activities. In *Lundgren v. Commissioner of Internal Revenue, supra,* the Court stated (376 F. 2d at 627, 628):

> "The holding of *Whipple* was that the furnishing of regular services to one, or many, corporations cannot constitute an independent trade or business where the taxpayer's motivation is that of an investor and gain is sought in the form of dividends or enchancement in the value of the investment. This is so, the Court reasoned, because

previous cases had established that 'investing is not a trade or business' within the meaning of the statute, and where a taxpayer seeks a return in the form of dividends or enchancement in the value of an investment 'this return is distinctive to the process of investing * * *' Id. at 202, 83 S.Ct. at 1174. Hence, the Court concluded:

> Absent substantial additional information furnishing management and other services to corporations for a reward not different from that flowing to an investor in those corporations is not a trade or business under § 23 (k) (4) (the predecessor of § 166 under the Internal Revenue Code of 1939). (Footnote omitted.) Id at 203, 83 S.Ct. at 1174."

. . .

"These are not the kinds of gains marking an investor's return, characterized in *Whipple* as gain from dividends or enchancement in the value of the investment. It may be true, as respondent points out, that one who has advanced substantial sums to a corporation in which he holds a controlling interest will expect an economic benefit from the investment over and above the normal remuneration for services rendered. But as respondent's stipulation recognizes, and as the Tax Court found, this expectation need not always take the form of an investor's return. *It is the kind of return the lender seeks that Whipple emphasizes;* and where the return sought is shown to be different from that flowing to an investor, *Whipple* leaves open the question whether a taxpayer's services to his corporation may constitute an independent trade or business." (Emphasis added).

Appellants will demonstrate that they were engaged in two businesses—furnishing services as employees in return for compensation, and leasing real estate—and, that the loans in question were made for the purpose of furthering those businesses.

B. The Business of Performing Services as an Employee.

In *Whipple v. Commissioner of Internal Revenue, supra,* the Supreme Court stated that performing services to a corporation, in and of itself, does not constitute a trade or business; however, the Court noted at 373 U.S. 204, 205:

> "Nor need we consider or deal with those cases which hold that working as a corporate executive for a salary may be a trade or business, E.g., *Trent v. Commissioner,* 291 F.2d 669 (C.A.2d Cir.). Petitioner made no such claim in either the Tax Court or the Court of Appeals and, in any event, the contention would be groundless on this record *since it was not shown that he has collected a salary from Mission Orange or that he was owed one.* Moreover, there is no proof (which might be difficult to furnish where the taxpayer is the sole or dominant stockholder) that the loan was necessary to keep his job or was otherwise proximately related to maintaining his trade or business as an employee. Compare *Trent v. Commissioner,* supra." (Emphasis added).

When discussing whether petitioner's services as a corporate executive for a salary constituted a trade or business, the Supreme Court noted in footnote 12 that under the net operating loss carryover provisions, and under the Internal Revenue Code sections relating to

ordinary and necessary expenses of a trade or business, the performance of personal services as an employee is considered carrying on a trade or business.

The case of *Trent v. Commissioner of Internal Revenue* (2nd Cir., 1961), 291 F. 2d 669, 674, contains an extensive study into the question of whether performing services as an employee constitutes engaging in a trade or business under Section 166 of the 1954 Internal Revenue Code. The Supreme Court, in *Whipple, supra,* did not specifically affirm or overrule the decision in *Trent,* but rather raised an issue as to the proximate relationship of the debt incurred therein to the employment status. The decision in *Trent* is scholarly and well reasoned. The Court spends a great deal of time reviewing the definition of "trade or business" as applied to the employee status under other Internal Revenue Code sections. It is noted that five courts of appeals have held that being a corporate employee is a "trade or business" under Section 172(d)(4) of the 1954 Internal Revenue Code. The Court also noted that:

> ". . . the decided weight of authority long has been that a corporate officer may deduct expenses paid or incurred which were incident to the 'trade or business' of being a corporate employee . . .",

under Section 162(a) of the 1954 Code (291 F. 2d, at 674). Petitioners consider the *Trent* case, *supra,* to be compelling authority for the position that performing services as an employee constitutes a trade or business.

Since *Trent, supra,* the rule has become rather well settled that performing services in return for compensation constitutes engaging in a trade or business. *Lundgren v. Commissioner of Internal Revenue, supra; Wed-*

dle v. Commissioner of Internal Revenue (2nd Cir., 1963), 325 F. 2d 849, 851; *Kelly v. Patterson* (5th Cir., 1964), 331 F. 2d 753.

Irving Ninberg was President of Bur-Val and was in charge of the office and sales personnel. Ben held the office of Secretary in the corporation and was in charge of production. The record indicates that appellants were performing substantial services for Bur-Val Manufacturing Company, and that they received substantial salaries for their services. During the years 1959 and 1960, Irving and Ben Ninberg each received a salary of $34,500.00 annually [Exs. 1-A, 2-B, 5-E, 6-F]. The Commissioner has never attacked the reasonableness of these salaries. When asked what his trade or business was during the year 1957, Irving Ninberg replied that he was employed by the Bur-Val Manufacturing Company [Tr. 11]. In response to the question of why the petitioners had guaranteed the purchases of Bur-Val Manufacturing Company from Harvey Aluminum Company, Irving Ninberg replied, in part, that the corporation was paying his brother and him a fair salary [Tr. 17].

The Court notes that if the corporation had ceased business the petitioners would have lost their employment [Clk. Tr. 49, 50]. It states,

> "So far as the record shows petitioners would have been able to obtain more highly remunerative employment . . . than they were obtaining from Bur-Val."

This conclusion is *entirely without foundation* as the possibilities of employment elsewhere—other than at Bur-Val—were not considered by either party, and there is no testimony on this point.

The Lower Court also notes:

> "Petitioners' argument that the guarantee was connected with continued receipt of their salaries is unpersuasive. They withdrew large salaries for two years and then none at all when the corporation's business was less profitable. Thus, they also sacrificed this non investor's return to the welfare of the corporation." [Clk. Tr. 53].

The Court obviously used this fact to conclude that the appellants' testimony to the effect that they wished to protect their jobs lacked credibility. Such a finding is unwarranted. *Lundgren v. Commissioner of Internal Revenue, supra.*

In *Lundgren, supra,* the Court of Appeals for the Ninth Circuit reversed a decision of the Tax Court (T.C. Memo 1965-314). The petitioner therein had done business in the form of a partnership. The partnerships existence was terminated, and a portion of the assets were transferred to RushMore Corporation. RushMore needed funds for expansion and attempted to secure a loan of $250,000.00 from the United States Small Business Administration. As a condition of the loan, the SBA required the petitioner to act as a guarantor of said loan and to advance an additional $145,-000.00 of his own money to the corporation. He was also required to make all personal sales to said corporation at cost, and to draw no salary until the SBA loan had been repaid. RushMore subsequently ceased doing business and the taxpayer sustained a loss of $129,-000.00. The issue before the Court was the business vs. non-business character of the loan.

The Tax Court had held that the taxpayer was not engaged in business as an employee of RushMore.

The Court of Appeals reversed on this point, and also found that the loans were made in connection with that trade or business.

The Court noted at pages 627-628:

> "It may be true, as respondent points out, that one who has advanced substantial sums to a corporation in which he holds a controlling interest will expect an economic benefit from the investment over and above the normal remuneration for services rendered. But as respondent's stipulation recognizes, and as the Tax Court found, *this expectation need not always take the form of an investor's return.* It is the kind of return the lender seeks that *Whipple* emphasizes; and where the return sought is shown to be different from that flowing to an investor, *Whipple* leaves open the question whether a taxpayer's services to his corporation may constitute an independent trade or business.
>
> . . .
>
> "We having found petitioner to be in the trade or business of rendering managerial and other services to RushMore, it follows that the debt involved here bore that proximate relationship to this trade or business which satisfies the 'in connection with' requirement of the statute. . . . RushMore's existence depended upon its ability to obtain the financing necessary to put its South Dakota operations under way. *If the SBA loan had not gone through, the corporation—and petitioner's job with it—would have been finished. In a direct sense, therefore, the advances were related to petitioner's trade or business activities in connection with*

RushMore. See *Weddle v. C.I.R.,* 325 F.2d 849, 851 (C.A.2, 1963).

"In so holding, we reject the Tax Court's conclusion that petitioner could not have been in the business of providing services to RushMore because he never received a salary from RushMore. Conditions of the SBA loan prohibited RushMore from paying its officers any salary without the SBA's permission. In all his previous timber and lumber enterprises petitioner's gain was realized through the sale of timber at a profit and receipt of a salary for services rendered, and petitioner's testimony that RushMore was formed to provide more of the same kind of gain as soon as the SBA restrictions were removed is *not disputed. In determining whether the services rendered a corporation constitute the conduct of a trade or business, the anticipated gain need not be realized immediately.* (Citation) *That gain will not be recognized until some future time is but one factor to be considered in determining whether the loss claimed arose from a trade or business activity of the taxpayer or from activities peculiar to an investor.*" (Emphasis added).

The Lower Court in this case was strongly influenced by the fact that petitioners reduced their salary when the corporation incurred financial difficulties, and based upon this fact, chose to disbelieve the petitioners' statements of their intent. *Lundgren, supra,* clearly points out that it is the long term anticipated gain which is to be considered, and that a temporary failure to receive the anticipated income should not be the sole determining factor.

The Lower Court also states the following [Clk. Tr. 52]:

> "Intentions alone cannot make a bona fide business expense out of an item which is not necessary to the conduct of the business. Therefore, the courts have looked to see if the loan to the corporation was required of the shareholder if he seeks to justify it by his employment status. Even though a stockholder is not actually required to make the loan by the deeds of his personal business, a fairly direct and clearly beneficial effect on his personal business interest has been held to cause the bad debt."

The Courts should not look to see if the loan was required by the shareholder—at least, should not give this factor great weight. In *Weddle v. Commissioner, supra,* the Court expanded the philosophy of the *Trent* case to cases where the employee is also the controlling stockholder:

> "That Mrs. Weddle, unlike Trent, did not have to fear being fired by a superior is also not at all conclusive as to what she was trying to protect; she would have been fired soon enough if the company had to cease operations through inability to obtain credit—as she was when it ultimately did." (325 F. 2d, at 851).

The Court in *Weddle* realistically stated that executives in a corporation need not be warned about losing their job, but, rather can intelligently ascertain that same will be nonexistent should the corporate employer be forced to close its doors. See also the cases of *Kelly v. Patterson, supra; Lundgren v. Commissioner, supra.*

C. Business as Lessor.

In *Whipple v. Commissioner, supra,* the Supreme Court reversed the decision of the lower court for the following reason (373 U.S. at 205):

> "We are more concerned however, with the evidence as to petitioner's postiion as the owner and lessor of the real estate and bottling plant in which Mission Orange did business. The United States does not dispute the fact that in this regard petitioner was engaged in a trade or business (footnote 13: *Although petitioner received no rental payments* form Mission Orange, there was rent owing to him under the 10-year lease agreement.) but argues that the loss from the worthless debt was not proximately related to petitioner's real estate business. *While the Tax Court and the Court of Appeals dealt separately with assertions relating to other phases of petitioner's case, we do not find that either Court disposed of the possibility that the loan to Mission Orange, a tenant of petitioner, was incurred in petitioner's business of being a landlord.* We take no position whatsoever on the merits of this matter but remand the case for further proceedings in the Tax Court." (Emphasis added).

The above quotation demonstrates that the Government conceded that *Whipple's* position as the lessor of the property used by his corporation constituted a trade or business.

In *Mahoney v. Spencer* (9th Cir., 1949), 172 F. 2d 638, 640, the taxpayer owned all of the shares of three corporations. He also owned plants which he leased to each of those corporations. The leases provided that

as landlord he agreed that he would provide adequate financing for each corporation's operation. The Court of Appeals held that these factors, as established in the District Court below, justified the holding of that Court that the taxpayer was engaged "in the business of acquiring, owning, expanding, equipping and leasing food processing plants."

In *Commissioner of Internal Revenue v. Moffat* (3rd Cir., 1967), 373 F. 2d 844, 847, the Court noted that the business of owning and leasing coal lands constituted a trade or business. In explaining the decision of the Tax Court below (T.C. Memo 1965-183), the Court noted that it was not necessary to *operate* the coal lands in order for the owning and leasing of same to constitute a trade or business.

Irving and Ben Ninberg were in the business of leasing the San Fernando building to Bur-Val on a five-year lease commencing October, 1959, at $3,000.00 per month [Stip. 3, Clk. Tr. 33; Tr. 15]. During the calendar year 1961, the year in which the transactions in question took place, the partnership of Irving and Ben Ninberg received gross rental income of $40,800.00, and realized a net income of $12,408.98 [Ex. 9-I]. The appellants each reported the following sums of rental income from the San Francisco building:

Year	Income
1959	$ 1,400.60
1960	9,770.88
1961	6,204.49
1962	(18,806.74)

The rental loss for the year 1962 includes the bad debt deduction now at issue. Without considering the bad

debt deduction, each partner realized income in the amount of $3,240.53 by renting the San Francisco property to Bur-Val Manufacturing Company.

In addition to the San Fernando property, Irving Ninberg had some interest in two other rental properties during the years 1959-1962.

Bur-Val occupied the San Fernando building under a sub-lease prior to its purchase by appellants. The corporation paid $1,500.00 rent per month to the sub-lessor although the sub-lessor was paying $3,500.00 per month to the owner of the property. Appellants purchased the San Fernando building and land in October of 1959 for $255,000.00 and leased it to Bur-Val for $3,000.00 per month. The sum of $55,000.00 was paid as a down payment, and appellants agreed to pay $2,-500.00 per month for three years, at which time the balance would become due. The interest rate was 6½%.

The above represent findings of fact by the Lower Court [Clk. Tr. 41]. The Court also found that the petitioners guaranteed obligations of Bur-Val to Harvey Aluminum Co. in August of 1961. Ben and Irving were anticipating a need to refinance the San Fernando property because the final lump sum payment would be due in October of 1962. The appellants stated that the guarantees were made in order to keep a tenant in the San Fernando property so that the purchase loan could be refinanced. In response to a question as to the appellants' intent in acquiring the San Fernando Road property, Irving Ninberg stated [Tr. 15]:

> "Well the same as the other rentals I have acquired that at one time we would be able to take care of my brother and myself after we wouldn't be able to physically work."

The assets of Irving and Ben Ninberg were given as collateral for the Bank of America loans because [Tr. 16]:

> "Well, for one thing, that the borrowing was getting quite large, and the bank wanted more security than just a personal guarantee for the amount of money that we were borrowing, and we figured that we would guarantee the amount due to the fact that we would have a tenant that would be in the property at all times."

The Harvey Aluminum guarantee was entered into because of even more demanding circumstances. That company was the corporation's principal supplier [Tr. 17]. Harvey Aluminum demanded a guarantee because of the weakness of the entire aluminum industry at that time, and,

> "My brother and I, as I stated before, were in a process of re-negotiating for the mortgage on the property, and we felt that we would rather keep the Bur-Val alive and have it as a tenant in the property, and we signed a guarantee to Harvey." [Tr. 31].

A more detailed statement of the problem facing the petitioners is found in the Transcript at page 17. Irving states:

> "Well, we figured that at the time that the corporation was paying both my brother and myself a fair salary, and that in order to keep the corporation alive so that we would have a tenant because at that particular time our mortgage with Mr. Carter was almost to a point where he had to refinance.

> "We tried to refinance. We were turned down by both Bank of America and Gibralter Savings. At that particular time they told us to come back at a future date at which time they would refinance the property. We figured that at that time it would be wise for us to have a tenant so that we could refinance at the time when we can go back either to Gibralter or the Bank of America."

Ben Ninberg similarly stated that the Harvey Aluminum guarantee was entered into because of the problems surrounding the refinancing of the property, and the need to retain the tenant. When asked what would have happened if they had not signed the guarantee, Mr. Ninberg replied, "We just wouldn't have no tenant." He also stated that, "With a tenant in the place then we were able to refinance the property." [Tr. 40].

On cross-examination, Ben Ninberg was asked why he put up the building as a guarantee of the obligations of Bur-Val to Harvey Aluminum. Mr. Ninberg replied that if the corporation didn't have any metal, it was out of business, and that he was more concerned about having a tenant in the property than about staying in business,

> ". . . because we had a lot of money involved in the property, and I didn't want to lose the property and lose the tenant and lose everything." [Tr. 44].

The guarantee of the Bur-Val Manufacturing Company obligations to Harvey Aluminum by the petitioners was limited to the extent of their equity in the properties on San Fernando Road and Lake Street [Ex. 19-S]. Each of these properties was used by the

corporation during the period 1957-1963 [Tr. 13]. The evidence above clearly demonstrates that there was an absolute need to refinance the San Fernando Road property; that if the collateral agreement and guarantee were not executed the corporation would be deprived of its source of financing to meet its ever-changing business needs, and its source of metals, and would then be forced to cease business operations. *Without the tenant, renegotiation of the financing would be impossible; without renegotiation of the financing, the property would be lost.* Therefore, the petitioners had nothing to lose by guaranteeing the Harvey Aluminum obligations to the extent of their equity in the real estate.

Why did the Lower Court choose to disbelieve the uncontradicted testimony of the petitioners that they intended to keep a tenant in the San Feranando property to assure refinancing of the property, and subsequent rental income?

The Court states that beginning sometime in 1961 Bur-Val was not paying rent when it fell due, and concluded that such a tenant would hardly be well regarded by a prospective financier [Clk. Tr. 53]. The partnership tax return for the year 1961 [Ex. 9-I] shows rental income from the San Fernando building of $40,800.00. The monthly rental was $3,000.00, which should have produced an annual rental income of $36,000.00. The Court's finding of fact is therefore contrary to the evidence.

The Lower Court also states that appellants could have received a higher rent from an unrelated tenant [Clk. Tr. 49, 50]. This finding is again unsupported by the evidence as Bur-Val was able to rent the property for $1500.00 a month from an unrelated lessor,

but Bur-Val paid $3,000.00 a month to appellants. We ask: Were the appellants, in light of the rental charged, most concerned with their business as lessors, or with the corporation's business. The record demonstrates that the appellants primarily were interested in benefiting themselves as lessors.

III.

Relationship to Individual Trade or Business.

It is well established in the case that a taxpayer may deduct worthless loans receivable as business bad debts when the loans are related to his individual trade or business. The standard to be used in determining whether the loans are sufficiently related to this individual trade or business is unclear. Section 166(d)(2) of the Internal Revenue Code of 1954 defines a non-business debt as any debt other than "a debt created or acquired (as the case may be) *in connection with* a trade or business of the taxpayer; or a debt the loss from the worthlessness of which *is incurred* in the taxpayer's trade or business."

The standard set by the statute—"in connection with" or "incurred in" a taxpayer's trade or business—is uncertain so the Commissioner drafted regulations to clarify the test. Tres. Reg. Sec. 1.166-5(b) states:

> ". . . The question whether a debt is a non-business debt is a question of fact in each particular case. The determination of whether a loss on the debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially the same manner for determining whether a loss has been incurred in a trade or business for the purposes of Section 165(c)(1).

> For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by the subparagraph. The use to which the borrowed funds are put by the debtor is of no consequence in making a determination under this paragraph . . ."

The problem, of course, is that the standard of "proximate relationship" is no clearer than the standard found in the statute, *i.e.,* "in connection with" the taxpayer's trade or business. The Courts have attempted to fill the void by defining when a loan is proximately related to the individual's trade or business. The Court-created standard looks to the motive of the taxpayer to determine whether the proximate relationship exists.

The only case to thoroughly discuss a precise standard is *Weddle v. Commissioner of Internal Revenue* (2nd Cir., 1963), 325 F. 2d 849, 851. The Court stated:

> "Here the Tax Court, recognizing the law to be as we had stated, rested its denial of a deduction on a factual finding that, unlike Trent, Mrs. Weddle had failed to sustain her burden of showing that protection of the trade or business of employment had been a *significant motivation* for endorsing the notes. . . . So here particularly in view of the back-handed wording of Section 166, it suffices for deduction that the creation of the debt

> should have been *significantly motivated by the taxpayer's trade or business, even though there was a non-qualifying motiviation as well.* But this, we believe, was the standard the Tax Court in fact employed." (Emphasis added).

The Court examined the law of torts in determining how the concept of "proximate" causation was to be interpreted, and found that a cause contributing to harm may be found proximate despite the fact that it might have been secondary to another contributing cause. In a concurring opinion, Judge Lombard felt that the standard should be one of "primary and dominant" motivation, rather than "significant" motivation.

In *Kelly v. Patterson* (5th Cir., 1964), 331 F. 2d 753, 757, the Court noted the majority and concurring opinions in *Weddle, supra,* and concluded that,

> "It appears then that the only problem under facts such as those here presented of loans by a *majority stockholder-employee* to the corporation is to determine whether the debt qualifies as trade or business incurred on any statutory basis, *and this depends on the motiviation of the taxpayer in making the loans which created the debt.*" (Emphasis added).

The Court concluded that the taxpayer had not met her burden under either of the standards asserted in *Weddle,* but clearly indicated that the motivation of the taxpayer was the controlling factor.

In *Lundgren v. Commissioner of Internal Revenue, supra,* this Court noted at p. 628:

> "RushMore's existence depended upon its ability to obtain the financing necessary to put its South Dakota operations underway. It the SBA loan

had not gone through, the corporation—and petitioner's job with it—would have been finished. In a direct sense, therefore, the advances were related to Petitioner's trade or business activities in connection with RushMore. See *Weddle v. C.I.R. . . .*"

After favorably citing *Weddle supra,* the Court noted that the advances were made to an enterprise distinct from, but "directly related to and formed in aid of" the petitioner's individual business. (376 F. 2d 628). The direct relationship found in *Lundgren* was no greater than that existing in this case, as will be discussed below.

The Tax Court has taken a variety of positions in attempting to define the necessary relationship between business loans and the taxpayer's individaul trade or business. In *J. T. Dorminey,* 26 T.C. 940, 945, the Court found that the advances were incidental to and proximately related to the petitioner's individual trade or business. This case was cited with approval by the Supreme Court in *Whipple v. Commissioner of Internal Revenue, supra,* in Footnote 11. "The significant motiviation" test was used in *Raymond E. Morrow,* (appealed by taxpayer to C.A.8th). Some Tax Court cases still define the issue as determining the taxpayer's dominant or primary motive; see *e.g. Philip W. Fitzpatrick,* T.C. Memo 1967-1, where the Court found that the taxpayer's dominant motive was to protect his employment.

The Lower Court noted that it is proper to search for the motive of a shareholder in making a loan or guaranteeing a corporate obligation. In determining the actual motive, courts consider the expressed subjec-

tive intent and the external objective facts, such as percentage of ownership of the corporation by the stockholder-guarantor, the value of the taxpayer's equity in the corporation, the value of salary received, and the ratio between the equity in the corporation and other interests which might have influenced the taxpayer's action. After this generally accepted statement of law, the Court notes [Clk. Tr. 52]:

> "The Courts look beyond motive, however, in searching for 'proximate relationship.' Intentions alone cannot make a bona fide business expense out of an item which is not *necessary* to the conduct of the business. Therefore, the Courts have looked to see if the loan to the corporation was required of the shareholder if he seeks to justify it by his employment status. Even though a stockholder is not actually required to make the loan by the needs of his personal business, a fairly direct and clearly beneficial effect on his personal business interests has been held to cause the bad debt to be considered a business bad debt." (Emphasis added).

The above statement demonstrates that the Court was not solely concerned with motivation, but that it also considered the actual necessity of the loans to further the taxpayer's individual business. Such a test is improper and cannot be supported by the volumes of case law discussing the issue of business vs. non-business bad debts. This Court expressly rejected a similar argument in *Mercer v. Commissioner of Internal Revenue* (9th Cir., 1967), 376 F. 2d 708, 710, 711, in which the Court determined that expenditures in raising cattle were deductible as business expenses,

rather than non-deductible hobby expenses. The Court noted that:

> "Unquestionably, however, in this circuit the rule is that a taxpayer's venture is a trade or business if he has a good faith expectation of profit from that venture, irrespective of whether or not others might view that expectation as reasonable . . . Here the taxpayer entered into a venture with a good faith expectation of profit. Whether that expectation was foolhardy or shrewd is of no moment. The taxpayer expended his effort and capital to the limit of his available time and resources. There can be no conclusion other than that the taxpayer's venture, though small in results, was a trade or business within the meaning of Sections 162 and 165."

As in *Mercer, supra,* it is improper in this case to question whether the loans were actually needed to further the taxpayer's trade or business. The proper test to be employed is whether the taxpayer guaranteed the loans in question while motivated to protect his individual trade or business by saving his job or rental property.

Conclusion.

The Court must determine, relying upon the evidence presented at trial, whether the acts of appellants in guaranteeing the corporate loans of Bur-Val Manufacturing Company were "investment" oriented or promoted by an "income protection" motive.

Appellants believe that the evidence presented at trial clearly demonstrates that they were concerned about losing their jobs at Bur-Val Manufacturing Company, and further concerned with the possibility that they

would be stranded without a tenant at that crucial time when the San Fernando Road property had to be refinanced. As appellants controlled Bur-Val Manufacturing Company, they were not concerned about the possibility of being fired. They were, however, realistically apprehensive about the possibility that Bur-Val Manufacturing Company might be forced to cease doing business. This, in fact, happened through the occurrence of various transactions in 1961 and 1962, and appellants found, as they had anticipated, that jobs paying them $34,500.00 per year vanished. The San Fernando Road property was also lost—not sacrificed for the sake of Bur-Val Manufacturing Company, the "corporate entity"—but rather realistically pledged as security in a desperate attempt to generate salaries and a substantial rental income for appellants.

The record before the Court does not detail the complete history of Bur-Val Manufacturing Company from its inception in mid-1957 through its demise in 1963. Financial data pertaining to appellants and Bur-Val Manufacturing Company for the years 1959-1962 is found in the record, and an analysis of these years furnishes ample evidence of the fact that appellants were significantly motivated when guaranteeing and paying the obligations to Bank of America by their desire to obtain substantial salary and rental income.

Appellants testified that the corporate obligations were guaranteed because the corporation was paying them a fair salary [Tr. 17], and because it was necessary to keep a tenant in the San Fernando Road property [Tr. 16, 17, 40, 44]. Appellants were particularly concerned about the need to refinance the San Fernando Road property, since the note was due in 1962. They

believed they had nothing to lose by guaranteeing the obligations in question, and incurring future obligations, as it will be demonstrated below that their investment in the corporation was nominal, while their investment in the rental property was great. Appellants do not suggest that the success of the corporation was not a factor. Of course it was. What we respectfully suggest though, is that there were tiers of priority, to wit: (1) protect the property—rent, (2) protect the salaries, (3) protect the corporate stock.

Appellants believe that the Lower Court disregarded the evidence which we feel substantiates the appellants' oral expression of their motivation—the disparity in value between the combined salary-rental income—investment in real property, as contrasted with appellants' investment in the "corporate entity"—Bur-Val Manufacturing Company.

The cases place a great deal of emphasis on the factor just discussed. In *Whipple v. Commissioner of Internal Revenue, supra,* 373 U.S. at 196, the Court noted that Whipple's bad debt deduction amounted to $56,975.10, while his investment in the real estate in question amounted to but $43,601.00, but the Supreme Court directed the lower court to rule on this issue. In *George P. Weddle* (1962), 39 T.C. 493, 497, affirmed 2nd Cir., 325 F. 2d 849, both courts pointed out that the corporation's net worth varied between $204,000.00-$337,000.00 in the relevant years, while the salary that the petitioner was attempting to protect was approximately $18,000.00 per year. This comparison aided the courts in determining the petitioner's motivation.

In *Frank A. Garlove,* T.C. Memo 1965-201, the Court relied on the same theory—comparing the investment with the claimed income protection motivation:

> "Respondent's contention that the petitioner advanced $15,000.00 to protect a capital investment of $7,040.00 in a small company is unsupported by the record and unsounded in theory. The mere fact of stock ownership in the debtor corporation is not significant by itself to overcome the weight of petitioner's evidence that the primary purpose of the loan was to aid petitioner's business."

The Court also noted that, "by helping the company to continue its operations as profitably as possible, the petitioner hoped to get future business."

The following schedule demonstrates the total capital investment of appellants in Bur-Val Manufacturing Company [Exs. 13-M through 16-P]:

Taxable Year Ended	Common Stock	Earned Surplus	Total Capital Investment
4/30/59	25,000.00	22,735.99	47,735.99
4/30/60	25,000.00	43,075.73	68,075.73
4/30/61	25,000.00	(9,031.47)	15,968.53
4/30/62	25,000.00	(4,623.11)	29,623.11
4/30/63	25,000.00	(111,069.74)	(86,069.74)

Besides having a limited capital investment in Bur-Val Manufacturing Company, that investment was financially unproductive as the corporation had never paid dividends [Tr. 18, Clk. Tr. 40]. Contrast the above capital investment in Bur-Val Manufacturing, particularly the investment as of April 30, 1961 (under $16,000.00) and April 30, 1962 (under $30,000.00), with the appellants' investment in the real estate located at

3000 North San Fernando Road. The down payment in 1959 was $55,000.00, and additional payments were made in the amount of $2,500.00 per month (including interest at 6½%) [Clk. Tr. 41]. In all, appellants invested in excess of $100,000.00 in the San Fernando Road property [Tr. 40]. The comparison of the investment in the capital stock ($15,000.00-$30,000.00) with the investment in the real estate (in excess of $100,000.00) is concrete, tangible evidence of appellants' intent when guaranteeing the obligation to Harvey Aluminum Company and furnishing collateral for the bank loans. Contrast the comparative investments above with those discussed by the courts in the *Weddle, Whipple* and *Garlove* cases quoted above.

The Lower Court apparently accepted the above evidence, finding:

> "Although the evidence is not clear on this point, it appears that their equity in the building substantially exceeded their equity in the corporation. Nevertheless, other factors indicate that petitioners' expressed intent was not their real intent." [Clk. Tr. 53].

Appellants believe that the trial Court did not give proper weight to the above comparison; rather it relied on less significant factors that were, for the most part, not supported by the record.

The law is clear that a corporate entity is a taxpayer distinct from its shareholders and employees. Yet, when determining the motivation of appellants herein, the legal distinction is less meaningful than the in-

dividual's intentions. Irving Ninberg stated why the corporate form of business was chosen [Tr. 19]:

> "Well, because of the other assets my brother and I both have, we figured it would save us for (from) any kind of lawsuits, or things like that that might prevail."

That statement presumably means that the corporate form was chosen for the manufacturing operation in order to limit individual liability from that venture. The true business interests of appellants were obtaining a "fair salary" [Tr. 17] and paying off the mortgage on the real estate. These two objectives motivated appellants' actions during the years in question.

We believe that appellants are described by their own words in the record. They emerge as hard working people with the traditional goals of bettering themselves and their families. They were interested in social security—the personal kind; not the Government variety. Therefore, they personally invested in income property in the reasonable anticipation of developing passive income to provide for their wants when they become older [Tr. 15]. The program of paying the purchase price on the San Fernando Road property in the partial sum of $90,000.00 (including interest) over a three-year period would create a larger equity, and upon refinancing for a more orthodox period, a dramatic cash flow would have presented itself. That the plan was aborted signals a minor economic tragedy.

Following the purchase of the building in 1959, all business activity was directed to that day when the property would be refinanced and a substantial rental income would result. The Court's own analysis [Clk.

Tr. 42] of the income of appellants for the years 1959-1962, belies its later conclusion that the protection of rental income from the San Fernando Road property was not foremost in appellants' minds in the years in question. The income schedule of Ben and Mollie Ninberg presents the evidence in its purest form. Ben had no sources of income other than his salary and rental income from Bur-Val Manufacturing Company—income from his individual trade and business. When Bur-Val did well during 1959 and 1960, it was the individual appellants who reaped the benefit, *not Bur-Val Manufacturing Company.* Appellants each received a salary exceeding the corporation's earnings [Clk. Tr. 40, 42]. While the Lower Court relies upon the fact that the salary was terminated in the years 1961, and 1962, each of the appellants received income of $6,204.49 from the San Fernando Road building during the year 1961. During 1962, the year in which the corporation suffered its sharp loss, each petitioner still received $3,-240.00 in rental income from the San Fernando Road property (when disregarding the business bad debt deduction). It is this financial independence that appellants were attempting to develop, and would have developed had they been able to refinance the San Fernando Road property.

Appellants and the Commissioner agreed that the transactions in question were entered into for the purpose of sustaining Bur-Val Manufacturing Company. With the corporation successfully engaging in business, it could realistically pay the appellants substantial salaries, and guarantee them a tenant whom they knew and could rely upon. It is not difficult to see why appellants wanted to rent the property to a tenant whom

they knew—such a lease furnishes security, and that was the goal of appellants. The Commissioner contended that appellants wished to protect their investment in the corporation, and the trial Court agreed. Yet each failed to face the vital question: What investment? for it is indeed the substantial investment in the San Fernando Road property, as contrasted with the small investment in Bur-Val Manufacturing Company which lends tangible, concrete support to the appellants' testimony of their motivation and intent to protect their jobs and investment in the San Fernando Road property.

Respectfully submitted,

Bruce I. Hochman and
Harvey D. Tack,
Attorneys for Appellants.

Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

BRUCE I. HOCHMAN

HARVEY D. TACK

APPENDIX.

Table of Exhibits.

Exhibit	Identified	Offered	Received
Joint Exhibits 1-A to 11-K, 13-M to 19-S	3	3	4

Statute—Internal Revenue Code of 1954.

Sec. 166. BAD DEBTS

(a) General Rule

(1) Wholly Worthless Debts. There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) Partially Worthless Debts. When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

. . .

(d) Nonbusiness Debts

(1) General Rule. In the case of a taxpayer other than a corporation.

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) Nonbusiness Debt Defined. For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.